CHAPTER III

PROPOSALS TO RESTRUCTURE THE TAX SYSTEM

Many of the recent Congressional proposals for restructuring the tax system involve, to a greater or lesser degree, replacing the current system, which taxes income, with one that primarily taxes consumption. The main purposes are to encourage saving and investment and to simplify the tax code. The emphasis on taxing consumption is new. A decade ago, tax reform efforts focused on restructuring the income tax to make it fairer, simpler, and more efficient but did not attempt to replace it with a consumption-based tax.

Taxes based on consumption can take several forms and can be collected from businesses, individuals, or both. Like income tax systems, consumption tax systems can have either a single statutory rate or rates that vary among individuals and different types of consumption. Similarly, the base may be narrow or broad, and the system can include many tax preferences or none. The main types of consumption taxes are a retail sales tax, a value-added tax (VAT), and consumption-based taxes levied directly on households.

Retail sales and value-added taxes are collected by businesses. Both types of taxes can be broad-based or can exempt certain goods and services or certain types of businesses. The main difference between the two is that retail sales taxes are levied on final consumer purchases, whereas value-added taxes are levied at each stage of the production and marketing of goods and services. The value added by labor and capital at each stage determines the amount of tax owed at that stage. The methods for calculating value-added taxes vary (as outlined in Box 2) and can affect the treatment of nonprofit institutions.

The proposals for consumption-based taxes levied on individuals or households have taken two forms. Some proposals exclude interest, dividends, and capital gains from the tax base, whereas others tax all income but provide a deduction for net savings. The latter scheme is known as a consumed (or savings-exempt) income tax. By definition, income equals consumption plus saving. Thus, exempting savings from taxation is equivalent to taxing consumption.

The tax-restructuring measures discussed in this paper are not inclusive, but they illustrate the general nature of recent proposals. Most are based on consumption rather than income, and several call for flat rates. The proposals vary widely in their level of detail and in their treatment of charitable and other nonprofit institutions (see

BOX 2.
METHODS OF CALCULATING VALUE-ADDED TAXES

Three methods exist for calculating value-added taxes: the credit method, the subtraction method, and the addition method.

Under the credit method, the firm calculates the value-added tax (VAT) it owes by applying the tax rate to its sales. It then receives as a credit against its tax liabilities the VAT it has paid on purchases from other businesses, and it remits the difference to the government. The credit-invoice method, which most European countries use, requires the firm to show the VAT separately on all of its sales invoices and to calculate the VAT credit by adding all VAT shown on its purchase invoices. The credit method thus ensures against final purchase prices that include multiple layers of tax (that is, "cascading" of the VAT).

Under the subtraction method, also known as a business transfer tax, a firm pays tax on the difference between its sales and its purchases from other businesses, including buildings and equipment. The subtraction method does not require invoices.

Under the addition method, a firm calculates its VAT by adding up all payments for untaxed inputs and multiplying the added value by the tax rate.

Table 3). However, most of them are intended to raise the same amount of revenue as current tax laws. Thus, the tax rates in the proposals could change, if necessary, to avoid revenue losses. The bill numbers below refer to legislation introduced in the 104th Congress.[1]

A NATIONAL RETAIL SALES TAX

The National Retail Sales Tax Act of 1996 (H.R. 3039), introduced by Congressman Dan Schaefer and others, would replace the individual and corporate income taxes with a national retail sales tax of 15 percent on property and services. The tax base would include rents and leaseholds but would exclude exports and goods that were purchased for resale or to produce taxable property or services. Tuition payments for education or job training would fall into that last category and thus would not be subject to tax.

In general, H.R. 3039 would exclude from taxation dues, contributions, and payments to charitable and other nonprofit institutions. Payments for the goods and services of nonprofits would also be exempt, provided they were related to the organization's exempt purpose and were not commercially available.

1. See also Joint Committee on Taxation, *Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax*, JCS-4-96 (April 30, 1996).

TABLE 3. MAJOR PROVISIONS THAT AFFECT NONPROFIT ORGANIZATIONS IN SELECTED TAX-RESTRUCTURING PROPOSALS OF THE 104TH CONGRESS

Proposal	Tax-Exemption for Public Charities	Tax-Exemption for Other Nonprofits	Deductibility of Charitable Contributions: Individual	Deductibility of Charitable Contributions: Corporate	Preferential Treatment of Tax-Exempt Bond Interest
Current Law	Yes	Yes	Within limits[a]	Within limits[a]	Yes
H.R. 3039 (National Retail Sales Tax Act of 1996)	Yes	Yes	No	No	No
H.R. 4050 (VAT)	No[b]	No[b]	No	No	No
H.R. 2060 and S. 1050 (Freedom and Fairness Restoration Act of 1995)	Yes	Yes	No	No	No
S. 488	Yes	Yes	Limited to $2,500	No	No
Ten Percent Plan	Yes	Yes	No	No	Yes
S. 722 (USA Tax Act of 1995)	Yes[c]	No[c]	Within limits similar to current law	No	Yes
Bingaman-Daschle Proposal	Yes	No	Yes	No	Yes

SOURCE: Congressional Budget Office.

NOTE: VAT = value-added tax; USA = Unlimited Savings Allowance; AGI = adjusted gross income.

a. The limits in any year are 50 percent of AGI for gifts of cash to public charities and private operating foundations and 30 percent of AGI for gifts of appreciated capital gain property for individual contributions and 10 percent of taxable income for corporate contributions.

b. The goods and services of charitable and other nonprofit institutions would be exempt from tax only if the entity did not charge for them.

c. Most section 501(c)(3) organizations would be tax-exempt. The exceptions would be organizations that promote amateur sports or that sponsor seminars or conduct research to educate the Congress or the general public about policy issues. Qualified pension and employee benefit plans, certain real estate and title holding companies, cemetery companies, and cooperative hospital service and educational organizations would also be exempt. Other nonprofit entities, including social welfare organizations registered under section 501(c)(4), would be subject to the business tax on any transfer of goods or furnishing of services.

A VALUE-ADDED TAX

Legislation introduced by Congressman Sam Gibbons (H.R. 4050) would replace the individual income tax (for all but high-income taxpayers), the corporate income tax, and the Social Security and Medicare payroll taxes with a single-rate, subtraction-method value-added tax. The VAT rate would be 20 percent of the difference between a firm's gross receipts and its purchases of goods and services from other enterprises, whether for-profit or nonprofit. (Twenty percent is an estimate of the rate that, in combination with other provisions, would produce the same revenue and distributional effects as current law.) For purposes of the bill, a firm's purchases would not include employee compensation. If, during any taxable period, a business's purchases exceeded its gross receipts, the business would be entitled to a refund equal to the VAT rate times that excess.

Because the proposed VAT would most likely result in a tax increase for lower-income households and a decrease for upper-income households, the bill includes adjustments to make the tax burden, on average, similar to that under current law:

- Taxpayers with income between $30,000 and $75,000 would pay no income tax and file no tax returns.

- Taxpayers with adjusted net income of less than $30,000 would get a credit to offset their VAT payments. The credit would be 20 percent of adjusted net income, reduced by two-thirds of one percent for each whole $1,000 of the taxpayer's net income. (For purposes of the credit, the bill defines adjusted net income as the sum of adjusted gross income and the value of some nonindexed federal transfer payments.)

- Taxpayers with net income of more than $75,000 would pay a 17 percent flat rate on the amount of adjusted net income over $75,000. (For purposes of the assessment, the bill defines adjusted net income as adjusted gross income plus tax-exempt interest, some foreign-earned income that is excludable under current law, and items of elective deferred compensation.) The bill does not provide for any deductions from income—such as for state and local taxes, home mortgage interest, or charitable contributions.

The VAT base would include sales of goods and services by nonprofit entities, agricultural cooperatives, and state and local governments. The goods and services of tax-exempt organizations and government agencies would be exempt only if the provider did not charge for them. (However, public utility, mass transit, and

postal services that a government agency might furnish would be taxed, even if it did not impose a separate charge for them.) Corporate gifts would generally come out of net receipts, which would be subject to the VAT.[2]

FLAT-RATE CONSUMPTION TAXES

Proposals for consumption-based taxes include several that would impose a single statutory rate on businesses and individuals. Flat rates can apply to any tax base. With one exception, however, all of the proposals in the 104th Congress involve changing the base to consumption and eliminating many tax preferences.

H.R. 2060 and S. 1050

The flat-tax proposal introduced by House Majority Leader Richard Armey (H.R. 2060) and Senator Richard Shelby (S. 1050)—the Freedom and Fairness Restoration Act of 1995—would replace individual and corporate income taxes and estate and gift taxes with a wage tax on individuals and a cash flow tax on businesses. The tax on individuals would be levied on wages, salaries, pension benefits, and unemployment compensation, but not on Social Security benefits. In addition, Social Security contributions would be made from after-tax income, as under current law. The individual tax would include no deductions, but it would have exemptions of $21,400 for a married couple filing jointly, $14,000 for a single head of household, $10,700 for a single person, and $5,000 for each dependent. The individual tax rate, which would apply to the excess of income over exemptions, would start at 20 percent and drop to 17 percent when the system was fully phased in.

Businesses—corporations, partnerships, and sole proprietorships—would pay a tax on the difference between gross receipts and the sum of purchases from other firms, wage payments, and pension contributions. The rate structure would be the same as for the individual tax. Payments for fringe benefits, state and local taxes, and payroll taxes would not be deductible. The main difference between the proposed cash flow tax on businesses and a subtraction-method VAT is that the latter normally would not allow firms to deduct wages and pension contributions.

Nonprofit entities that are now tax-exempt would remain so and, as under current law, would be subject to tax only on income from unrelated business activities. They would, however, have to pay a tax equal to the cash flow tax on the value of employees' compensation other than wages, contributions to retirement

2. *Congressional Record*, September 11, 1996, pp. E1572-E1580.

plans, and payments for services performed outside the United States. Thus, employee fringe benefits, such as health and life insurance, would be subject to tax.

S. 488

The proposal introduced by Senator Arlen Specter (S. 488) is similar to H.R. 2060 and S. 1050. It would replace the individual and corporate income taxes with a 20 percent flat-rate consumption tax, consisting of a wage tax on individuals and a cash flow tax on businesses.

The individual tax would be levied on earned income (excluding income from foreign sources). In addition, employees of nonprofits and government agencies would have to add the imputed value of their fringe benefits to their wage base. Besides a "basic standard deduction," based on filing status, and an "additional standard deduction" for each dependent, S. 488 would allow individuals to deduct home mortgage interest on the first $100,000 of acquisition indebtedness and up to $2,500 for charitable contributions of cash or its equivalent.[3] The deduction for charitable contributions would be available for itemizers and nonitemizers alike.

The business tax would be levied on gross income minus the sum of purchases from other firms, the costs of tangible and real property, reasonable travel and entertainment expenses, wage payments, and pension contributions. (Deductions that exceeded revenues could be carried forward to the following year.) Charitable contributions by corporations would not be deductible.

H.R. 214 and H.R. 1780

Other proposals in the 104th Congress for flat-rate taxes include H.R. 214 and H.R. 1780. H.R. 214, the Crane Tithe Tax Act of 1995, would replace corporate and individual income taxes and estate and gift taxes with a 10 percent tax on the excess of an individual's earned income over a specified exemption amount. The bill would permit no exclusions from gross income, no credits against individual income taxes, and no deductions.

H.R. 1780 would replace corporate and individual income taxes with a 20 percent flat-rate tax on the earned income of individuals and on business taxable income. For individuals, it would provide a basic standard deduction, based on filing status; an additional standard deduction for each dependent; and a home mortgage

3. Acquisition indebtedness, as defined in section 163(h)(3) of the Internal Revenue Code, is incurred in acquiring, constructing, or substantially improving a residence.

interest deduction, limited to the first $100,000 of acquisition indebtedness; and a deduction for charitable contributions.

A FLATTER INCOME TAX

A proposal introduced by House Minority Leader Richard Gephardt—the Ten Percent Plan—would result in a flatter tax but would not change the base to consumption. Under the plan, three-fourths of all individuals and households would pay income tax at a 10 percent rate. For the remainder, the rates would be graduated in four steps, from 20 percent to 34 percent. The proposal would raise current personal exemption levels to $5,000 for single taxpayers and $8,350 for married couples. An additional personal exemption of $2,750 would be available for each family member. Social Security benefits would be treated as under current law.

The Ten Percent Plan would include tax-exempt interest, fringe benefits, and employers' pension contributions in gross income and would allow deductions only for interest paid on home mortgages. It would broaden the base of the corporate income tax by eliminating some $50 billion in preferences but would otherwise leave it intact. Taxes for smaller businesses would be lower than under current law.

TWO-TIER INCOME AND CASH FLOW TAXES

Some Members of Congress have proposed two-part tax systems that would modify the individual income tax and replace the corporate income tax with a cash flow tax similar to a subtraction-method VAT. Depending on the proposal, the revisions to the individual tax would either shift the base to consumption or leave it unchanged.

The Unlimited Savings Allowance Tax

The proposal introduced by Senators Pete Domenici and Sam Nunn (S. 722)—the Unlimited Savings Allowance (USA) Tax Act of 1995—would replace the individual and corporate income taxes with two consumption-based taxes.

For individuals, the tax base would consist of gross income minus net additions to savings and specified exemptions and deductions. Gross income would include wages, salaries, pensions, most fringe benefits, alimony, child support, interest, dividends, rents, royalties, proceeds from the sale of financial assets, and gains from the sale of nonfinancial assets. Gross income would not include proceeds from borrowing, interest on tax-exempt bonds, income from gifts and bequests,

health care payments and reimbursements, certain government transfer payments, veterans' benefits, military pay, and a portion of Social Security payments.

The net additions to savings that individuals could deduct from gross income would include acquisition of such assets as stocks, bonds, securities, and shares of mutual funds; certificates of deposit; investments in proprietorships and partnerships; life insurance policies; annuities; net new deposits in savings, money market, checking, credit union, and brokerage accounts; and contributions to retirement accounts. Additions to savings would not include investments in land, cash on hand, or collectibles. Borrowing would reduce (but not below zero) the deduction for net savings, as would interest earned on tax-exempt bonds.

Individuals would be entitled to personal exemptions of $2,550 for each member of the household, a family living allowance, and deductions for alimony, home mortgage interest, postsecondary education, and charitable contributions. Deductions for education would be limited to a maximum of $2,000 per person or $8,000 per household. Charitable contributions would generally be subject to the same limits specified in current law but would include the full market value of some donated property—specifically, real estate and tangible property that is related to an institution's exempt purpose, such as works of art donated to museums (which would not qualify for the savings deduction). Donors of marketable stock would be able to deduct the untaxed appreciation at the time of contribution. (The original cost would be deductible from income in the year of purchase.) Charitable contributions that exceed the deductible limit could be carried forward for up to five years. All other deductions, including those for state and local taxes, would be eliminated.

A progressive rate schedule—8 percent, 19 percent, and 40 percent after 1999—would apply to the individual tax base, with a credit for the 7.65 percent Social Security and Medicare payroll taxes that workers pay. Lower-income households would be eligible for an earned income tax credit similar to the existing one.

For businesses, a cash flow tax—essentially a subtraction-method VAT—would replace the corporate income tax. The tax base would be gross receipts minus business purchases and would be subject to an 11 percent rate. Gross receipts would not include interest, dividends, proceeds from the sale of stocks and bonds, or taxes. Business purchases would include employee compensation, interest and dividend payments, life insurance premiums, financial assets, and property purchased outside the United States other than imports. A credit would be allowed for the 7.65 percent payroll taxes that employers pay.

S. 722 would exempt most section 501(c)(3) charitable, religious, and educational organizations from the business tax (with the exception of income they

earned from unrelated business activities). Qualified pension and employee benefit plans, certain real estate and title holding companies, cemetery companies, and cooperative hospital service and educational organizations would also be exempt. Other nonprofit entities, including social welfare organizations registered under section 501(c)(4), would be subject to the business tax on any transfer of goods or furnishing of services. Section 501(c)(3) organizations that promote amateur sports or that sponsor seminars or conduct research to educate the Congress or the general public about policy issues would also lose their tax-exempt status.

The Bingaman-Daschle Proposal

The proposal introduced by Senators Jeff Bingaman and Tom Daschle—which is part of a larger plan designed to foster "family-friendly" policies—would modify the existing individual income tax and would replace the corporate income tax with a business activity tax. With a few exceptions, their tax proposal is similar to the one introduced in the 103rd Congress by (then) Senators John Danforth and David Boren.

Unlike other comprehensive tax-restructuring proposals, the Bingaman-Daschle plan would not replace the individual income tax with a consumption-based tax. Rather, it would alter the current tax by adding an extra standard deduction, reducing payroll taxes, expanding the earned income credit, providing a $500 credit for each child, and allowing a deduction of up to $10,000 for educational expenses. Charitable contributions would be affected only by the increase in the standard deduction. The exclusion for interest on tax-exempt bonds would remain.

The proposed business activity tax is essentially a subtraction-method VAT. All businesses with gross annual receipts of more than $100,000 would pay a flat-rate tax on the amount by which their sales exceeded their purchases from other businesses. Employer-provided benefits, such as health care and pension contributions, would not be deductible. The tax rate would be 11 percent for businesses that adopted "family-friendly" labor and environmental practices (such as offering acceptable profit sharing, health care, work training, and pension plans and maintaining an acceptable environmental record) and 18 percent for all other businesses. State and local governments would be subject to the tax on activities that were related to public utility services, mass transit services, postal services, and services not involving an "essential governmental function."

Nonprofits other than section 501(c)(3) institutions would be subject to the business activities tax, even if their activities were related to their exempt purpose. Charitable organizations would pay the tax only on unrelated business activities.[4]

TAX TREATMENT OF NONPROFITS IN COUNTRIES WITH VATs

The general form that most of the proposals to replace the corporate (and, in some cases, the individual) income tax have taken so far—the subtraction-method VAT—differs from the VATs in nearly all developed countries, where the credit method is more common (see Box 2 on page 18). The method of calculating the VAT has important implications for nonprofit institutions. The credit method allows for zero rating and thereby makes full tax-exemption feasible. An organization with a zero rating pays no taxes on the value of its sales and receives credit for taxes paid on its purchases. Under the subtraction-method VAT, by contrast, nonprofit organizations can be exempted from paying tax on the value of their sales minus purchases, but they will probably pay higher prices for their purchases to compensate for the VAT paid by their suppliers. In other words, under a subtraction-method VAT tax-exemption is partial, whereas under a credit-method VAT it can be partial or full.

Tax-exemption under a VAT or a cash flow tax can be based either on the nature of the institution or on the activities it performs. Although countries that impose broad-based consumption taxes have used both approaches, the more common practice is to exempt nonprofit institutions but to tax certain activities. In European countries, a nonprofit organization's noncommercial activities are exempt from tax, but its commercial goods and services that compete with those of private-market providers generally are not. Canada at times departs from that practice by taxing some nonprofit organizations but exempting certain activities. Canada also applies an exemption test based on taxable revenues that is the same for nonprofits and small businesses.[5]

Typically, certain goods and services are either exempted (that is, partially taxed) or zero-rated (that is, not taxed at all). The goods that European countries most commonly exempt or zero-rate are medical services, educational services, rental housing, and financial services. Some countries also exempt or zero-rate food, medicine, books, newspapers, museum admission charges, entertainment, and sports.

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4. Senator Jeff Bingaman, *Scrambling to Pay the Bills: Building Allies for America's Working Families* (February 28, 1996); also see Bureau of National Affairs, "Technical Overview, Legislative Language, and Memoranda on the Comprehensive Tax Restructuring and Simplification Act of 1994," *BNA Special Supplement*, Report No. 101 (May 27, 1994).

5. Robert Carroll, Thomas S. Neubig, and Kathleen M. Nilles, "Impact of Structural Tax Reform on Nonprofit Organizations," *Exempt Organization Tax Review*, vol. 12, no. 1 (July 1995), p. 106.

In most countries, exemption is more common than zero-rating. The United Kingdom and Ireland zero-rate about one-third of household consumption, which is significantly more than most other countries. Specifically, the United Kingdom zero-rates food, drugs, purchased housing, books, and newspapers and exempts medical, educational, and financial services and rental housing.[6]

The European Community has taken the position that activities in the "public interest"—such as postal services, medical and dental care, education, cultural activities, and noncommercial radio and television—should be exempt from VAT, regardless of the nature of the institution that provides them, which may be publicly or privately owned, charitable, nonprofit, or for-profit.[7]

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6. Alan A. Tait, *Value Added Tax: International Practice and Problems* (Washington, D.C.: International Monetary Fund, 1988), pp. 49-79.

7. Sixth Council Directive, European Community, as described in Tait, *Value Added Tax*, pp. 69-79.